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COMMENTS OF THE
CALIFORNIA STATE CONTROLLER'S OFFICE
ON THE
PROPOSED RULES OF THE MINERALS MANAGEMENT SERVICE
FOR THE
VALUATION OF CRUDE OIL
62 FED. REG. 3742

Submitted by,

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California State Controller's Office
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Valuation of Crude Oil
(62 Fed. Reg. 3742)

The following comments on the proposed rules of the Minerals Management Service (MMS) on the valuation of crude oil produced from federal leases (62 Fed. Reg. 3742) are submitted on behalf of the California State Controller's Office (SCO).

I. SUMMARY

SCO applauds MMS' attempt to fashion rules to capture the full value of crude oil for royalty purposes. The evidence is overwhelming that *any* reliance on the posted price system for valuation purposes will short change the federal and State governments, to the disadvantage of the public at large and the California State School system. SCO supports MMS' proposal to value crude oil produced in California by reference to the delivered price of Alaska North Slope (ANS) crude oil. The ANS price is the true value ascribed to California production by major companies internally and in their trades. The ANS price also represents a value that is less subject to the influence and manipulation of market actors. Currently, there is no better market price in California that better reflects the value of production.

Unfortunately, SCO cannot support MMS' proposals with regard to other major provisions, particularly the means it has proposed for the calculation of location differentials in

California. MMS' proposal for the calculation of location differentials, we believe, effectively scuttles ANS valuation. Moreover, in many instances, it will allow double dipping of transportation related costs and place the federal government in a worse position in terms of collection of royalties than exists under current regulations, ironically to the benefit of the very companies that are responsible for the undervaluation of California crude oil. Finally, much of the information that MMS intends to collect for purposes of calculating location differentials is irrelevant to the task or will yield inaccurate results. SCO recommends an alternative method for determining location differentials, outlined below, which it suggests MMS use in the short term for no longer than three years.

Although MMS proposes admirable steps to minimize its scope, SCO does not support MMS' continued reliance on the gross proceeds benchmark method for valuation of crude oil, rather than as a minimum acceptable value. In California, continued application of the gross proceeds benchmark method will result in payment of royalties on the basis of the now discredited posted price system. Acceptance of such undervalued prices is inconsistent with MMS' statutory obligation to collect full value in royalties. SCO believes that in the long run independent producers will be better assisted by rules that facilitate their ability to negotiate prices that better reflect the value of the crude oil they produce than by locking them into the disadvantages of the discredited posted price system. While SCO opposes the gross proceeds benchmark method, it also recommends alternatives to that approach that will better serve MMS' goal of limiting its application.

II. FORMAT OF SCO COMMENTS

SCO's comments are divided into three major parts: Valuation, Differentials, and

Section by Section Analysis. The first section discusses SCO's support for ANS valuation and its concerns over continued application of the gross proceeds benchmark method. The second section details the flaws in MMS' approach to determining differentials for California and other related issues. In both the Valuation and Differentials sections, SCO's comments are directed exclusively to the application of the MMS' proposed rules to production in California. The third section contains suggested modifications to other provisions in the proposed rules, all of which are aimed at strengthening and clarifying their application in a manner consistent with MMS' stated goals. Certain miscellaneous issues are addressed at the end of these comments.

SCO substantially agrees with the comments submitted by the City of Long Beach and incorporates those comments by reference herein. SCO also adopts by reference the findings on pages 44 - 52 of the Report of the InterAgency Task on California crude oil, Appendix 4 of that report, the reports of the Task Force consultants, and all of the documentation reviewed and considered by the Task Force from the files of the *Long Beach* cases.

III. VALUATION

A. Currently ANS Prices Represent The Only Reliable Basis For Collection Of The True Value Of California Crude Oil

1. Posted Prices Do Not Reflect The True Value Of Crude Oil

It is the Secretary's statutory responsibility to collect the royalties owed on production from federal leases on the basis of the true "value" of that production. *See e.g.*, 30 U.S.C. §226. "Value" is not synonymous with "price received." This truism has been reflected in Interior's regulations, both past and present; in the decisions of the Interior Board of Land Appeals, and in the case law. *See e.g.*, *Foster v. Atlantic Refining Co.*, 329 F. 2d 485 (5th Cir.

1964); *U.S. v. Ohio Oil Co.*, 163 F.2d 633 (10th Cir. 1947), *cert. denied*, 333 U.S. 833 (1948); *Amoco Production Co.*, 85 IBLA 121 (1985); *Supron Energy Corp.*, 46 IBLA 181 (1980). The Secretary has wide latitude in establishing regulations for the collection of royalties so long as those regulations are designed to capture value.

In light of his statutory obligations, the Secretary commendably formed an InterAgency Task Force to study the undervaluation of crude oil in California. After many months of study, which included obtaining the advice of experts and reviewing the voluminous documentation obtained by California in the *Long Beach* cases, the Task Force concluded in a Report, adopted by the Department, that posted prices in California do not reflect the value of crude oil production.

SCO believes that on the issue of undervalued posted prices the most insightful evidence sustaining the Task Force's conclusions is contained in Appendix 4. While Appendix 4 abstracts only a small portion of the documentary evidence reviewed and considered by the Task Force, it demonstrates that, contrary to the "conventional wisdom," access to California crude oil was highly valued in the refinery market.

Why? Their reasoning was simple, California crude oil could be obtained at cheap, undervalued prices. Major oil companies, most of whom set the field posted prices, would value California crude oils both internally and in trades among themselves at substantially higher prices than the prices they posted in the field. Undervalued posted prices allowed companies in California to obtain cheap access to crude, maintain the highest refinery margins in the country, and reduce their royalty and tax obligations.

What price did these companies use to determine the true market value of California crude oil? These companies viewed the spot prices paid for ANS in California as the true market value of the crude oil.

SCO believes that the evidence abstracted in Appendix 4, even standing alone, overwhelmingly demonstrates both that posted prices in California are undervalued and that the ANS price reflects industry's own understanding of the true value of California crude oil. As MMS is aware, the cumulative weight of the full documentation considered by the Task Force all leads to the same inescapable facts and conclusions highlighted in Appendix 4.

There is further evidence, of an equally overwhelming nature, that posted prices in California were undervalued. Sell-offs by both the State and federal government consistently yielded premiums over posted prices. Sales by "marketing affiliates" of producing lessees were made at premiums over posted prices. At least one major company, ARCO, sold large volumes of its Wilmington crude at premiums over postings. And oil companies, including majors, purchased crude oil at premiums over postings. The Federal Trade Commission recognized the two tier pricing system in California in its consideration of the Texaco/Getty merger. The FTC ordered Texaco to continue supplying independent refiners at posted price. Texaco protested on the grounds that postings were below market. FTC, Texaco Inc. and Getty Oil Inc., Proposed Consent Agreement, 49 Fed. Reg. 8550, 8561 (March 7, 1984). California postings have been and continue to be consistently below postings for comparable crudes in the Gulf.

In short, among the industry in California, the undervaluation of posted prices has been an open secret -- a secret maintained at the expense of the federal and State governments.

2. The value of California crude oil is appropriately set by reference to ANS prices

As noted, there is little doubt that part of industry's open secret was its own determination that ANS spot prices reflected the true value of California crude oil. Beginning in the late 1970s, large volumes of ANS have been purchased for use in California refineries. Between 1980 and 1994, for example, ANS accounted for almost 45% of the total crude consumed in California refineries.

Also since the early 1980s, refiners in California have viewed ANS as the crude available in adequate supply to meet their needs. ANS crude competes directly with California crude in the refinery market. Accordingly, ANS prices and California crude prices should compare favorably; ANS prices should be the basis of a competitive price for California oil. This, however, has not been the case. Rather, ANS prices, adjusted for both quality and location, have been consistently and significantly higher than posted prices for California crude oil.

As MMS notes, there are spot markets, other than the ANS spot market, in California. MMS is correct in rejecting these alternative spot market prices as a means of valuing California crude oil. Only a small volume of California crude oil is traded in these markets; indeed these spot markets reflect only two or three trades per month. It is our understanding that representatives from Platts confirmed that these markets are thinly traded and would not represent to MMS that the information it obtained on these minor spot markets was reliable. This was particularly true for the Line 63 and Wilmington spot markets. While Platts was slightly more comfortable with the Kern River spot market, it apparently recognized that the prices in the market were influenced by the posted price system.

This is somewhat consistent with SCO's own review of the Kern River spot market prices. That review revealed that from January 1985 to August 1996, the average monthly difference between Kern River spot prices, based on information from both Platts and Telerate, and the comparable posted price was 4 cents. Clearly, the thin trades at the Kern River spot market are being influenced by the undervalued posted prices. Moreover, it is SCO's understanding that Platts generally does not derive its information from confirmed deals in these California spot markets. Rather, Platts relies on bid offers and reports those numbers. Because these spot markets are impacted by the low level of actual trades in California, a huge difference can exist between what information a company may provide a Platts reporter and the prices at which a company actually trades.

Finally, the bulk of federal onshore production comes from the San Joaquin Valley where there are no heated common carrier pipelines available for use by lessees. All the production from federal public lands in California is heavy crude oil. The Department of the Interior can no longer ignore the impact that the proprietary operation of the heated pipelines in California has had on the value of crude oil production. Both of the Task Force consultants highlighted the "critical effects" of these proprietary pipelines, conclusions that were adopted as part of the Task Force findings:

> First, it greatly restricted open-market trading in California crude oil; second, it segregated the crude oil markets of the San Joaquin Valley and Ventura Basin from the refining centers in San Francisco and Los Angeles. The reports concluded that the pipeline situation contributed to postings substantially understating California crude oil values. They also concluded that while these captive prices were far below the value of California crude oil to refiners, ANS crude oil was relatively free to seek a value nearer its true value.

Task Force Report at pp. 47 - 48. While the above quotation references posted prices, it is clear that the Kern River spot market is at the wrong end of the proprietary pipeline system in California. Crude oil traded in that market still must face the transportation problems associated with the proprietary pipeline system and the thin trading conducted in that market reflects that fact. SCO notes that Interior's Inspector General reached nearly identical conclusions in its report on the California pipeline system.

Currently use of ANS prices is the only viable alternative for valuation of production for royalty purposes in California. California refineries obtain most of their crude oil from California or Alaska. The federal government, along with the companies, have long recognized that California constitutes a separate market. Thus, the California market is sufficiently distinct from the markets east of the Rockies to justify use of a different value indicator. Nonetheless, ANS pricing has remarkable history of tracking the NYMEX, which in and of itself supports the current use of ANS as a valuation method.

3. A safety net for valuation should be specifically established

MMS recognizes the need to continue to monitor its proposed index prices to assure that they reflect full value. While currently, SCO believes that reliance on ANS prices will assure the collection of the true value of federal production, it supports a program of continued review and monitoring. However, SCO believes that MMS should go further and specifically establish a safety net valuation method that would be used by MMS in the event that its monitoring reveals aberrational pricing.

MMS states that in the event that its chosen index prices become unavailable or no longer reflect reasonable value, it will simply undertake another rulemaking. 62 Fed. Reg. at 3745;

Proposed §206.102(c)(3), 62 Fed. Reg. at 3753. The rulemaking leading to the 1988 regulations took over two years to complete. Nearly a year has passed since the Task Force issued its report finding that posted prices do not reflect value and recommending ANS prices as the appropriate valuation method. The comment period on the current rulemaking has already been extended twice and is anticipated to be extended at least once more. Industry lobbied heavily to extend the deadline for 120 days and it can be expected that its behind the scenes efforts will not end once the comment period closes. Each month of delay in issuing new regulations is costing the federal and State governments hundreds of thousands of dollars, if not millions. A promise of a new rulemaking in the event that an index price is unavailable or deemed not to yield full value is simply not a viable alternative in the face of potential financial loss to the government.

SCO is confident that reliance on ANS pricing will currently yield a fair value for federal crude oil production. Indeed, some have taken the position that, at times, use of ANS prices would yield an overly conservative value. *See* Task Force Report at p. 48 n. 19. In light of the experience in California with the posted price system; the potential for changes in the market (such as the lifting of the export restrictions on ANS crude, *see* 62 Fed. Reg. at 3745, and the changing configuration of the participants in the California market, realism dictates a healthy distrust of the maintenance of the status quo. SCO is aware of industry's attacks on ANS pricing on grounds that it is thinly traded. These attacks are fiction -- ANS, as noted, accounts for well over one third of the crude oil consumed in the California refinery market. The documentation made available to the Task Force confirms this fact. Nonetheless, SCO recognizes that the ANS spot market is not as protected against influence as the NYMEX and that, thus, what is currently fiction can more easily become fact.

For these reasons, SCO recommends that MMS establish in these rules, at least for West Coast federal production, a "safety net" method for valuation of federal production, which would be used only if the ANS price becomes unavailable or fails to yield a reasonable value. Studies performed for California show that ANS price movements have tracked movements in NYMEX, although ANS prices have consistently been lower due to quality factors. From 1987 to 1996, the absolute price difference between ANS and the NYMEX has ranged from $0.96 to a high of $4.87; in terms of absolute price ANS has been about 4 to 20 percent lower than the NYMEX; in more recent years, 1994-1996, the average difference between ANS and NYMEX has narrowed considerably.

Based on this data, SCO recommends that MMS establish a safety net for ANS pricing at 20% below the NYMEX price, which is the most conservative approach. If, as MMS postulates, ANS prices are unavailable or fall to a level greater than 20% below the NYMEX for a period of six months, the safety net valuation would apply until (1) the ANS price normalizes (in which case the ANS price would apply) or (2) a new valuation rule is promulgated.

Accordingly, SCO recommends that Proposed §206.102(b)(3) [62 Fed. Reg. at 3753] be modified to read as follows (changes underlined, deletions bracketed):

> (3) MMS will monitor the index prices in paragraph (c)(2) of this section.
>
> <u>(i)</u> If MMS determines that NYMEX [or ANS spot] prices are unavailable or no longer represent reasonable royalty value MMS will, by rule, amend paragraph (c)(2)<u>(i)</u> of this section to establish a substitute valuation method.
>
> <u>(ii) If ANS spot prices are unavailable or fall to a level greater than 20% below average NYMEX prices for a period of six months, you must value production</u>

subject to paragraph (c)(2)(ii) at 80% of the average NYMEX price until either of the following events occur: the ANS spot prices normalize, i.e. rise above the 20% limit set above, or MMS establishes by rule a substitute valuation method.

B. The Gross Proceeds Valuation Benchmarks Should Be Abandoned

1. Calculation of royalties by gross proceeds is a complicated process that will not invariably yield the true value

Under §206.105(a), MMS proposes to allow lessees to value production by reference to the gross proceeds received under arm's length contracts. To its credit, MMS has proposed exceptions to application of §206.105(a) in order to limit its scope in situations where the evidence shows that gross proceeds will not be a reliable indicia of true value. These include oil disposed of under exchange agreements, oil subject to crude oil calls, gross proceeds including buydowns, and contracts that are part of a continuous course of dealings between the parties. While SCO supports all of these limitations, it does not believe that MMS has gone far enough to put in place limitations that will assure the receipt of true value. Indeed, SCO believes that problems inherent in the gross proceeds methodology counsel in favor of its abandonment.

First, at least in California, accepting arm's-length gross proceeds will continue to result in royalties paid on the basis of posted prices. Gross proceeds in California have rarely reflected the true value of the production. This is primarily due to the proprietary operation of the three major heated pipelines. The pipeline owners, as discussed above, are major companies who also set the field posted prices. Because these companies have an incentive to purchase cheap oil, they typically pay prices lower than true value, as the Task Force Report noted. Major companies rarely pay prices over posted prices, and even when they do, they do not pay a price near that at which they internally value the production, the ANS price. SCO notes that this problem could be substantially alleviated if the Department of the Interior would enforce the Mineral Leasing Act common carrier requirements.

SCO understands that MMS has concerns about adversely impacting small independents. However, the Task Force found that posted prices in California, in fact, understate the value of production, and both the relevant statutes and lease terms require payment of royalty based upon value. Requiring payment from all producers based upon the indexes may provide an incentive to independents to more aggressively market their production and seek to change whatever market characteristics are prohibiting them from obtaining full value, which after all is part of their obligation to the lessor. MMS should not support by rule a pricing system that locks independent producers into receipt of less that true value for their production. These independents, to the extent payment on the basis of indexes would cause them substantial hardship, would still have the opportunity to seek value determinations from MMS.

Second, accepting arm's-length gross proceeds opens the door to manipulation, especially through so-called daisy chain transactions. In these types of transactions, which were frequent during the price control years, "non-affiliated" companies accommodated each other by transferring, on paper, production at "arm's length" and then re-transferring the production to the producing company (or its affiliate). *See e.g.*, *Port Petroleum Inc.*, 21 DOE ¶83,007 (1991). *See also Phoenix Petroleum v. U.S. FERC*, 95 F.3d 1555 (Fed. Cir. 1996); *Mapco Intern. Inc. v. FERC*, 993 F.2d 235 (TECA 1993); *Cities Service Oil & Gas Corporation*, 66 FERC ¶61,222 (1994). Both the revelations of the Task Force and the information revealed during MMS's internal review underscore that MMS should not be blind to the fact that lessees have an incentive to reduce their royalty obligations.

Third, accepting arm's length gross proceeds gives rise to the need for complicated definitions. As one example, SCO notes MMS's proposed definition of "exchange agreement." While SCO agrees with the principle that exchange agreements should not be considered arm's length, we note that MMS has omitted from its definition multi-party exchanges, time exchanges, overall balancing agreements, net-out agreements and crude for finished product exchanges, among others, all of which are common in the industry. Reliance on indexes reduces the need for defining types of transactions that will eventually prove under-inclusive simply because MMS was not aware of a particular industry practice or could not predict how crude oil would be transferred in a changing market.

Fourth, accepting arm's length gross proceeds taxes the limited resources of MMS. For example, the MMS proposal will require auditors to review all a lessee's contracts to assure that it did not purchase crude oil from its buyer of federal production anywhere in the Nation. The time pressures placed on the MMS audit and administrative appeals process by the new Federal Oil and Gas Royalty Simplification and Fairness Act all but mandate that MMS put in place regulations that can be easily applied, that will not depend on tracing of complicated transactions, and will not be subject to interpretive and factual disputes.

2. Affiliate sales gross proceeds simply adds a second layer of complication to an unreliable valuation standard

Under Proposed §206.105(c)(1), MMS proposes to adopt as the first benchmark for non-arm's length transactions, the gross proceeds accruing under arm's length sales by an affiliate to a lessee.

SCO recognizes that MMS is pursuing audits of affiliate sales in order to capture premiums paid over postings and SCO supports MMS's efforts as one means under the current regulations to capture the true value of federal production. Indeed, SCO was the first audit team to uncover the premiums being received through affiliate sales. However, SCO is also aware that application of the gross proceeds methodology is cumbersome, costly, and invites disputes over document access and contract interpretation. While SCO does not question MMS's authority to pursue affiliate sales gross proceeds nor the proposition that such proceeds are a closer indicia of value than posted price, there is nothing that mandates that MMS retain the gross proceeds methodology when more certain, simpler and truer methodologies, such as indexes, are available.

All of the problems associated with the gross proceeds methodology that SCO outlined above also infect valuation under Proposed §206.105(c)(1). The problems are exacerbated because acceptance of an affiliate's gross proceeds will also require MMS to sort through the problems of commingled oil and multiple sales by an affiliate; problems that will all require for their resolution access to documents from entities that consistently oppose MMS audits and document access requests.

Typically an affiliate will commingle its purchase of federal production from a particular lease with its purchases from other leases, federal or non-federal. After it is commingled, it is impossible to trace the federal production to a particular affiliate sales contract. This will enable companies to allocate the federal production to their lower priced sales contracts; indeed they will have an incentive to do so. SCO notes that MMS simply fails to address the issue of commingling in Proposed §206.105(c)(1), and appears either to assume that federal production will be sold as such by an affiliate or to permit the lessee to allocate the federal production to the sales contract it chooses. MMS' proposal does not, thus, even guarantee payment on the basis of gross proceeds.

By simplifying the applicable valuation methodologies, MMS will be able to free up and direct resources to the most problematic area of the proposed valuation regulations, location differentials.

3. Gross proceeds should be used, if at all, only on an exceptions basis

SCO believes that adoption of ANS pricing as the sole determinant of value for California production would be the most efficient method of valuation and the only method that will result in the collection of the true value of federal production.

SCO, however, is not unsympathetic to MMS' concern for the impact of its proposals on small, independent producers. At least in California, it is true that many small, independent producers have been locked out of obtaining open market values for their crude oil. While SCO believes that, given the federal government's royalty interest, the more appropriate role of the government is to provide incentives for beneficial market changes and to take action to correct known market problems (*e.g.*, enforcing the common carrier requirements of the Mineral Leasing Act), SCO recognizes that such changes might be slow in coming.

Yet, MMS' proposals for gross proceeds valuation, both under §206.105(a) and §206.105(c)(1), are not designed to apply solely to small, independent producers who might face unique circumstances in marketing their oil, *e.g.*, low volumes, lack of transportation, remote lease location. Even with the laudatory limits that MMS has proposed on the application of those rules, the gross proceeds valuation methodology will remain available to a larger segment of the industry than MMS predicts. SCO again notes, by way of example, the ability of companies to enter into "daisy chain" transactions. Under such transactions, even crude oil that is ultimately destined for consumption in the producer's own refinery can travel through one or several "arm's length" contracts.

Finally, any retention of the gross proceeds valuation method opens the MMS' proposed rules to potential challenge. As noted, at least in California, the gross proceeds method will not result in the collection of true value -- the statutory standard for calculation of royalties. To the extent that the gross proceeds methodology results in a valuation based on posted price, which it often will, the potential for challenge by royalty beneficiaries becomes even greater given the overwhelming evidence discrediting posted prices as a standard for determining value. Nor should MMS underestimate the creativity of industry lawyers, who will certainly assert that <u>any</u> recognition of posted price valuation undercuts index based pricing. Thus, if MMS is to retain a gross proceeds method of valuation, it must do so in a manner that protects the federal government's overriding interest in collection of the full value of federal production. It can only hope to achieve this through assuring that an adequate record exists justifying use of the gross proceeds valuation method in exceptional circumstances.

For these reasons, SCO suggests that if MMS chooses to retain a gross proceeds valuation method, it should recast Proposed §§ 206.105(a) and 206.105(c)(1) as exceptions to valuation based on index pricing. In addition to the limitations MMS has already placed on application of that method, it should: (1) confine use of the gross proceeds valuation method to small, independent producers; (2) require such producers to submit documentation demonstrating their marketing constraints; and (3) include provisions aimed at assuring that the transaction is truly a "sale" as defined under Proposed §206.101. Moreover, given the evidence discrediting any valuation based on posting, MMS should in no event accept a valuation based on posted price under the guise of the gross proceeds valuation method. Rather, if a small, independent producer's contract references posted prices a basis for determining value, it should propose an alternative method for valuing its production based on all relevant matters.

SCO suggests the following regulatory language:

[ ] *May I seek an exception to value based on an index price?* You may seek an exception to valuing your production on the basis of an index price.

(1) To be eligible for an exception, you must certify and provide appropriate documentation that:

(i) You are an independent producer who does not operate a refinery, is not affiliated with any company operating a refinery and produces no more than 20,000 barrels in any one state; and

(ii) You are unable due to exceptional circumstances from obtaining a better market for your production. Examples of exceptional circumstances include: low volumes of production for sale, remote lease location and transportation constraints.

(2) Under the circumstances described in paragraph (1) above, MMS may permit you to value your production on the basis of the gross proceeds accruing to you under an arm's length contract. If you sell or transfer your production to an affiliate and that affiliate disposes of the oil under an arm's length contract, MMS may permit you to value your production on the basis of the gross proceeds accruing to your affiliate under its arm's length contract. Valuation on the basis of your gross proceeds or the gross proceeds accruing to your affiliate will not be accepted and you must value your production by reference to the applicable index price if:

(i) the production is disposed of under an exchange agreement;

(ii) the production is subject to crude oil calls;

(iii) you or any of your affiliates purchased crude oil, gas, NGLs, or finished or unfinished products from an unaffiliated third party in the United States in the 2-

year period preceding the production month;

(iv) the arm's length contract does not qualify as an actual sale of crude oil, as sale is defined in §206.101;

(v) the production sold under the arm's length contract was subsequently sold or transferred back to you or an entity affiliated with you;

(vi) the production sold under the arm's length contract was subsequently sold or transferred under circumstances in which you received proceeds from the subsequent sale;[1]

(vii) the arm's length contract references posted price(s) as a basis for determining consideration. Under such circumstances you may propose an alternative method for valuing your production based on other relevant matters;

(viii) the gross proceeds include payments made to reduce or buy down the purchase price of oil to be produced in later periods. Under such circumstances, you must allocate such payments over the production whose price the payment reduces and account for the payment as proceeds for the production as it occurs.

(ix) your affiliate purchases oil from both you and others and sells such commingled production under more than one arm's length contract. In such circumstances, gross proceeds shall be determined under the arm's length contract with the highest value basis.

(3) Any determination by MMS that permits you to value your production on a basis other than the index price shall be subject to review and audit. If audit reveals that you were ineligible for an exception based on any of the factors listed in paragraphs (1) and (2), you will be obligated to pay the difference between the royalty payments you made and the applicable index price. You must also pay interest on the difference computed under 30 CFR §218.54. You will also be obligated to pay the difference between the royalty payments you made and the applicable index price, plus interest, if review and audit reveals:

(i) the gross proceeds you reported as royalty value did not reflect the total consideration actually transferred either directly or indirectly from the buyer.

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[1] SCO notes that this provision is directed at a trading practice that it has reason to believe is being used or contemplated by the independent sector. Under this practice, independents "sell" their production to an association at arm's length. The association then sells the production for a higher price and kicks back the premium to the independent.

(ii) the value reported by you does not reflect the reasonable value of the production due to either: (A) misconduct by or between you or your affiliate and the other contracting party, or (B) breach of the duty to market the oil for the mutual benefit of yourself and the lessor.

(iii) you or your affiliate participated as a buyer of oil, gas, NGLs, or finished or unfinished products within one year after the time for royalty payment has passed. If such an event occurs, any exception granted under paragraphs (1) and (2) is automatically inapplicable as a basis for valuing your production and you will required to base value on the applicable index price.

(4) In addition to the requirements set forth in paragraphs (1) through (3) above, to be eligible for an exception from valuation based on an index price, you must

(i) certify that the contract upon which your exception is based is an arm's length contract and that its provisions include all of the consideration the buyer must pay, either directly or indirectly, for the oil.

(ii) base your royalty payments on the highest price that can be received through legally enforceable claims under the contract. If you or your affiliate fail to take proper or timely action to receive prices or benefits under the contract, you must pay royalty at a value based upon that obtainable price or benefit. If timely application is made for a price increase or benefit under the contract but the purchaser refuses, and you or your affiliate take reasonable documented measures to force purchaser compliance, you will owe no additional royalties unless or until you or your affiliate receives monies or consideration resulting from the price increase of additional benefits. This paragraph will not permit you to avoid your royalty payment obligation where a purchaser fails to pay, pays only in part, or pays late. Any contract revisions or amendments that reduce prices or benefits to which you or your affiliate are entitled must be in writing and signed by all parties.

As MMS will note, this suggested language is virtually identical to the language in its Proposed §§206.105(a), 206.105(b) and 206.105(c)(1), but recast as an exception rather than as a benchmark valuation method. The substantive changes SCO has recommended include those noted directly above regarding a definition of independent producer and inclusion of a specific requirement that the contract reflect a true "sale" of the production.

SCO also included provisions addressing the commingling of crude oil purchased by affiliates, which as noted previously is not addressed in MMS' proposal. In that regard, SCO has recommended that MMS require that value be determined by reference to the contract with the highest value basis. This is not only the most administratively efficient means of valuing, it also will represent the value closest to the index price and thus closest to the true value of the production.

SCO has also included a provision that recognizes that reciprocal sales impacting gross proceeds can occur subsequent to the date of the contract. Under the MMS proposal, a federal royalty lessee may sell its federal royalty oil production in one month and use the gross proceeds method of valuing the production, even though the lessee has agreed to purchase oil or other products from an unaffiliated party in a subsequent month. MMS' rationale for excepting such reciprocal arrangements from the scope of its gross proceeds valuation method applies equally to subsequent transactions and there is no rational basis for ignoring the subsequent dealings of the lessee.

Finally, SCO recommends that the provision dealing with lessee purchases from unaffiliated parties in the United States include more than purchases of oil. This is in recognition of the fact that lessees may obtain benefits through reciprocal trades for other products.

In the event that MMS disagrees with SCO about addressing the gross proceeds valuation method as an exception, SCO would still recommend that its gross proceeds benchmarks, §§206.105(a) and 206.105(c)(1) be modified to include SCO's recommendations as reflected in SCO's proposed subsections (1)(i), (1)(ii), (2)(iii) through 2(vii), and 2(ix). For MMS' convenience, SCO has included regulatory language reflecting such changes as additions to

§§206.105(a) and 206.105(c)(1) in Part V, the Section by Section Analysis, of these comments.

IV. DIFFERENTIALS

A. Serious Problems Exist With MMS' Proposed Method For Calculation Of Location Differentials For California Production

SCO agrees with MMS that the most problematic part of its proposed rules is the calculation of appropriate location differentials.

Clearly MMS is moving in the right direction in its consideration of location differentials. The basic paradigm MMS has constructed -- index point to market center to aggregation center to lease -- demonstrates that the agency's goal is determine the wellhead value for federal production by making adjustments to the value of the marker crude (*e.g.*, NYMEX) to account for its market advantages (or disadvantages).[2] Thus, the location differential adjusts for the difference in price for crude oil traded at two known, specified locations.

MMS and SCO appear to be in agreement on what a location differential is intended to capture. MMS and SCO also appear to agree on the difference in purpose between calculating differentials and the calculation of allowances. *See e.g.*, 62 Fed. Reg. at 3747 ("Although location differentials would reflect differences in value of oil at different locations, they are not transportation cost allowances"). Sincc a differential will yield a value at the lease for federal production, a lessee would not be entitled to a transportation allowance and the actual transportation costs incurred by lessees are of limited relevance.

At least as it regards California, however, SCO has serious concerns about the means that

[2] See e.g. Williams and Meyers, Manual of Oil and Gas Terms at p. 286 (defining "differential" as "[a] premium added to the price of oil by reason of certain advantages, e.g., a low sulfur content").

MMS proposes to use for determining location differentials. Generally, SCO's concerns revolve around (1) the reliability of the information MMS proposes to use to determine location differentials, and (2) the lack of a relevant relationship between much of the information MMS proposes to collect and use, and its paradigm for calculation of location differentials.

At the outset, SCO believes that some of the problems associated with MMS' treatment of differentials could be resolved through greater attention to its definitions of the relevant terms. We note that MMS has, indeed, provided definitions distinguishing between "transportation allowance," "location differential" and "quality differential." However in applying these terms, MMS melts these separate and distinct factors together in a manner that will adversely affect any effort to determine the true value of federal lease production, most often to the detriment of the government but also to the detriment of some lessees. SCO strongly suggests that in order to avoid confusion and assure accuracy that MMS segregate its treatment of "transportation allowance," "location differential," and "quality differential" in separate sections of its rules.

The clearest example of this flaw is MMS' assumption that "[l]ocation differentials ... also encompass quality differentials." 62 Fed. Reg. at 4742. While it is true that under some exchange contracts, relative location and gravity differences will be aggregated, it does not follow that such an aggregated differential will be relevant to determining either the location or quality differential of production from other leases. MMS' failure, under both its regulations and its proposed information collection system, to distinguish these clearly separate differentials will grossly distort the ultimate valuation of lease production. Another example of MMS' melting of the separate factors can be found in Proposed §206.105(c)(3)(2), which as discussed more fully below, will result in inflating the calculation of location differentials in California.

See also e.g., Proposed §§206.102(c)(2)(i); 206.102 (c)(2)(ii); 206.104(b); 206.104(c); 206.105(c).

This rulemaking was precipitated by MMS' recognition that the posted price system and the contractual arrangements that support it operate to deprive the federal government from receiving the full value for federal royalty production. MMS has recognized that through particular sales contracts (*e.g.*, affiliate sales or exchanges) or through a series of sales contracts (*e.g.*, §206.102(a)), companies have the ability to understate value for royalty and tax purposes, while realizing full value for themselves. MMS also appears to recognize, as it must, that it does not have the resources to actually sort through these contractual arrangements to determine a value for federal production. In short, what we hope MMS has learned through its inquiry is that what is stated in terms of price under any particular contract will not necessarily reflect the values realized by the parties thereto.

For purposes of value, these findings led MMS, very rightfully, to value production by reference to certain marker crude prices that are less subject to the "influence" of particular market actors. 62 Fed. Reg. at 3745. For California, MMS has proposed the use of spot prices for delivered Alaskan North Slope crude oil. MMS has not proposed to use other spot market prices in California because the evidence demonstrates that those markets are thinly traded. Id. ("[N]one of these prices attaches to large enough volumes for MMS to recommend that they apply as royalty value.") As discussed previously, this is an unassailable conclusion.

Yet, despite these findings, MMS proposes to rely on the same information that it has deemed unreliable for purposes of determining value for purposes of calculating location differentials. The result of MMS' proposal is virtual abandonment of ANS as the value standard, drastic inflation of location differentials and inclusion of "costs" that are simply unrelated to a determination of a true location differential.

1. Comparison of ANS spot prices and field spot prices captures more than the price difference attributable to location

One of the clearest examples of the problems with MMS' approach is found in proposed §206.105(c)(3)(ii) [62 Fed. Reg. at 3755], under which a location differential will be determined, in part, by the difference between ANS spot prices and the spot price at an aggregation point nearest the lease.

At the outset, SCO notes that, curiously, MMS has proposed use of this factor for calculation of location differentials only for California production. It does not appear among the applicable factors listed in §206.105(c)(1). Indeed the only use of "spot prices" under §206.105(c)(1) is for determining a differential between a market center and an index pricing point; a "leg" of MMS' paradigm that it recognizes does not exist in California. 62 Fed. Reg. at 3748.

SCO trusts that reference to spot prices at aggregation points under §206.105(c)(3)(ii) was a mistake resulting from MMS' attempt to separate treatment of location differentials in California from those east of the Rockies. Given MMS' support of the ANS standard of valuation under its proposed regulations and elsewhere, SCO assumes that the Service would not propose a method for calculation of location differentials that effectively abandons ANS valuation and replaces it with posted price valuation. This is indeed the net effect of application of §206.105(c)(3)(ii).

To demonstrate this, SCO refers to MMS' own example of Kern River spot prices. 62

Fed. Reg. at 3748. From January 1985 to August 1996, the average monthly difference between the Kern River spot price and the comparable posted price was 4 cents. As discussed previously, those spot prices, which were derived from Platts and Telerate, were influenced by the posted prices, the thin trading at the Kern River spot market, and the lack of common carrier pipeline access. Indeed, these are the very spot prices that MMS disregarded as a basis for valuation because the market was thinly traded.

SCO assumes that in proposing the difference in spot market prices in the field and at the index point for purposes of computing location differentials, MMS was operating under the belief that the difference in the spot prices for a crude at two different locations would approximate the location differential. As a purely theoretical matter, SCO agrees with this proposition. Where MMS has erred is in its application, at least in California.

The MMS proposition works to capture an estimated location differential only where the underlying price basis of the crudes (assuming appropriate gravity adjustments) are equal. Only then can the difference in the crudes at two different locations be said to approximate the cost of transportation. For simple example, assume hypothetically that there is a spot market for Kern River crude oil both in the field and in the Los Angeles market center. If Kern River heavy is traded in the field at $16/bbl and is traded in Los Angeles for $17/bbl, the estimated location differential is $1. Theoretically, it does not matter whether the crude was undervalued, so long as the crude was undervalued at both locations, the difference (absent other indications of excess profit taking in transportation) at the two locations presumably represents the location differential. In short, apples are being compared with apples.

However, where the underlying price basis of two crudes are not equal or comparable, the difference in price cannot be viewed as representing only a location differential. Rather, while the difference might include some portion attributable to a location difference, the bulk of the difference is attributable to the differing crude values.

In this proposed rule, MMS has recognized that posted prices do not reflect a reasonable price for valuation of crude oil in California. This finding presupposes that posted prices and ANS prices are not comparable, *i.e.*, that the difference between them is not solely attributable to location and/or quality. As demonstrated previously, field spot prices vary insignificantly from posted prices. And, MMS has recognized that the prices at spot markets, such as Kern River, are an unreliable measure of value because of the low level of volumes traded. Thus comparing Kern River spot prices at the lease with ANS prices will inflate the location differential. Indeed, it effectively gives back in the guise of a location differential much if not all of the ANS value. In short, determining location differentials by comparing the field spot prices with ANS spot prices is a comparison of rotten apples with California oranges.

Thus the net effect of MMS' proposal is to replace ANS valuation with valuation based on admittedly unreliable spot market prices that vary insignificantly from the very posted prices that MMS intends to move away from under its proposed regulations. Indeed, under MMS' proposal, California and the federal government are in a <u>worse</u> position than under the current regulations since MMS will also allow deduction of actual transportation costs to an "alternate disposal point" as a second part of calculation of the location differential under §206.105(c)(3)(ii). As MMS is aware, integrated companies in California that value based on field postings are not currently eligible for transportation allowances.

SCO believes that it would be possible, as a historical matter, to determine location differentials for onshore production in a manner consistent with MMS' apparent theory and preferred direction. For example, the posted prices of crude oils at different locations, say Midway Sunset in the Valley and Wilmington in Los Angeles, could be reviewed through a regression analysis, which would isolate those factors that explain the price difference, *i.e.*, the implicit location factor and gravity or other possible quality differences. While the posted prices for both Midway Sunset and Wilmington reflect undervalued crude pricing, as an historical matter that fact should not influence the comparison for purposes of calculating the differentials.

Especially if this rulemaking goes forward establishing commodity pricing as the basis for determining value, SCO is not comfortable that such a comparison will hold in the future. This will prove true if transportation practices currently followed offshore are emulated onshore. Nonetheless, SCO believes that by performing a regression analysis on the historical posted prices throughout the State, MMS would be able to calculate a location differential for future use onshore. Using full costs as a proxy for variable costs, it would be possible to adjust this over time to account for any cost increases. SCO is willing to act as a facilitator in this regard to make available to MMS California's expertise and information. The benefits of undertaking this exercise and adopting this approach is that it will provide a standard location differential that can be applied across the board to onshore production in California, obviating the necessity for determining and making adjustments as to the various points of movement under an exchange agreement (*see e.g.*, Proposed §206.105(c)(3)(i)) and the necessity of undertaking costly transportation cost audits (*see e.g.*, Proposed §§206.105(c)(3)(ii) to (iv)).

Unfortunately, a similar type of analysis will not currently work offshore California, at least not without substantial additional research and audit testing. This is due to the transfer pricing practices of several integrated companies operating offshore leases. These practices are reflected in both the posted prices and spot market prices for offshore production. The prime example of such a practice is the exorbitant profit taking on the 26 mile Point Arguello pipeline and on the Point Pedernales pipeline. *See e.g.*, Oil & Gas Journal (November 27, 1995).

2. Undifferentiated use of all types of exchange agreements will not produce reliable location differential information

MMS' proposed comparison of spot prices at aggregation points with ANS spot prices is not the only example of its over-reliance on questionable information for purposes of determining location differentials. Although its rationale is not disclosed, it apparently assumes that contractual provisions for differentials are somehow immune from the same type of transfer pricing practices that infect the crude value provisions or immune from longer term contractual arrangements between the parties.

It is not only the value of production that can be under-stated under exchange agreements. Differentials can be aggregated, so that what is attributable to quality and what is attributable to location cannot be determined. This lessens the reliability of application of those differentials to other trades. Differentials can be manipulated, attributing more to location than to quality in order to take advantage of the regulations. Indeed, the absolute or true value of differentials need not be stated in an exchange, so long as the parties -- through separate adjustments or through other long term dealings -- account for any differences owed.

And, as MMS is aware, there is evidence to suggest that some major companies are taking their profit in transportation rather than attributing it to production. At this point it is worth remembering why there is consideration being given to using commodity market based price indices in the first place. In simple terms, when a vertically integrated firm faces a value-based payment obligation, like a tax or a royalty, it can avoid or mitigate the payment by using the prices at which one division of the firm "sells" to the next division, shifting revenue from where the obligation is owed to where it is not. But if this can be done with the basic commodity, it can also be done with the services associated with producing the commodity.

In the oil industry, all of the incentives and opportunities for manipulating the basic commodity price exist for manipulating the price of the transportation service. At the simplest, a company's transportation subsidiary can overcharge its producing subsidiary for its services thereby reducing the wellhead price of the crude oil and, of course, the royalty. Companies can exchange transportation services making any prices ascribed purely nominal, subject to whatever values the parties wish. In some ways, the opportunities for concealing real transportation costs are even greater than those for the basic oil price. A barrel of oil, at some point, in some form, must be sold in a real transaction, but there may never be a real arm's length sale of "transportation" between a lease and a refinery.

SCO notes also that MMS does not propose to differentiate between types of exchanges for purposes of determining location differentials. Yet, the only type of exchanges that will produce relevant information on location differentials are "in/out" exchanges. In/out exchanges are those where one company transfers production to another company's pipeline and the latter transfers back an equal volume of crude oil at a different point along the same pipeline. On a line between the field and the market center, this would of course capture the value attributable to location.

Other types of exchanges will reference receipts and deliveries on different pipelines. The differential under such exchanges will include differences in quality. Also, purely as a matter of location, such exchanges will not reflect a location differential between the field and the market center. For example, in California there are East/West exchanges, the location differentials of which would be simply irrelevant for determining location differentials between the lease and the market center.

SCO believes that MMS intended to recognize the sole relevance of in/out exchanges to the determination of location differentials in its proposed definition of "Exchange Agreement," under which it segregates the treatment of, what it terms, "transportation agreements." Unfortunately, as currently drafted, MMS' distinct treatment of "transportation agreements" is an exception that swallows the rule. The "principal purpose" of all exchanges is arguably to provide transportation. *See e.g.*, 8 Williams & Meyers, pp. 365, 1157 (definitions of "exchange agreement" and "transportation by exchange"). MMS' attempted distinction only makes sense in terms of "in/out" exchanges. Failure to make this distinction more precise in its definition of exchange agreements will cause confusion in both the application of MMS' valuation regulations, §§206.102(a), 206.102(c)(1), and in its calculation of location differentials.

Accordingly, SCO recommends that the last sentence in MMS' proposed definition of "exchange agreement," §206.101, be modified to read as follows:

> For the sole purpose of calculations to be made under §206.105(c), the term "exchange agreement" includes only those agreements under which one company transfers production to another company's pipeline and the latter transfers back an equal volume of crude oil at a different point along the same pipeline.

3. The proposed rules allow for substantial "double dipping" in the calculation of location differentials

Even assuming that reliable location differential information could be had from exchange agreements, MMS' proposed use of that information will result in inflated location differentials. This results from the undifferentiated attempt to fit unique contracts into the MMS paradigm for crude movement from the lease to a market center.

MMS appears to assume that the location differentials in exchanges reflect the value between an aggregation point and the market center. In California, however, it has been our experience that the initial transfer of production occurs at the lease or in the field. Again, an example of this is the spot prices at Kern River, which are stated for production in the field, not at an "aggregation point." And, many exchanges in California reflect transfers from the lease or field. Yet, under §206.105(c)(3)(i), MMS proposes to calculate the location differential by adding the location differential stated in an exchange and the transportation cost between the lease and the aggregation point. But if the location differential in an exchange is at the lease, MMS' proposal will permit a lessee to recover the cost of transportation to the "aggregation point" twice. MMS simply does not address how location differentials are to be determined when exchanges occur at the lease; it simply assumes that such transactions will fit its paradigm for calculation of location differentials.

This opportunity for "double dipping" is not confined to MMS' proposed use of exchange agreement information. It also is allowed under §206.105(c)(3)(ii), under which MMS proposes to add the difference between the ANS spot and spot prices at aggregation points nearest the lease, and actual transportation costs to "alternate disposal points." Again, SCO will use MMS' own example to illustrate. 62 Fed. Reg. at 3748.

Suppose Integrated Company (IC) produces crude oil in Midway Sunset and transports it to its refinery in Bakersfield, by-passing MMS' selected aggregation points. Under these circumstances, IC can deduct both the difference between the Kern River and ANS spot prices, and IC's actual transportation costs to its refinery. Yet, the Kern River spot price is quoted for production at the lease. Even if reliable, it already includes an implicit location differential relative to the value of ANS at the market center/index pricing point. MMS, however, will allow IC to recover a second amount, actual costs, that mirrors the location differential imbedded in the Kern River spot price -- a double deduction for the location difference between the lease and the market center.

4. The proposed rules permit reliance on irrelevant and inaccurate information for purposes of calculating location differentials

SCO is also concerned that MMS will permit the use of irrelevant or inaccurate information in the calculation of location differentials.

Again, the clearest example is MMS proposed §206.105(c)(3)(ii). As noted, a location differential should capture the relative "value" of crude oil at specified, known locations. For MMS' purposes, these locations are (1) the lease and (2) the market center. Once the relative value of the crude at these two locations is determined, MMS has a wellhead value upon which to compute royalty. Where a wellhead value can be calculated, it is simply irrelevant where the federal lessee chooses to transport it. MMS' concept of a "floating" aggregation point or market center selected by a lessee -- MMS' "alternative disposal point" -- makes absolutely no economic sense in terms of determination of an appropriate location differential.

As noted, the end result, at least in California, is to allow lessees the benefit of both a location differential and a transportation allowance. Such a result is inconsistent with MMS' historic treatment of transportation allowances, which are allowed only where value is not determined at the wellhead.

Thus, at least as it regards California, SCO opposes all reliance on costs to "alternate disposal points" for calculation of location differentials.

MMS opens the door to a second source of irrelevant information under proposed §206.105(c)(1)(iii). Under that proposed section, MMS states that it will collect location differential information from exchange agreements to be used for publication of differentials.

SCO again notes that MMS does not propose to differentiate between types of exchanges in collecting this information, although the only relevant exchanges for location differential purposes are in/out exchanges.

Second, SCO reiterates that location differentials in exchanges may not follow MMS' paradigm for determining location differentials. The differentials in exchanges may already account for transfers at the lease, or they may reflect partial transportation. An example of a partial exchange in California would be where the lessee delivers oil to the pipeline company at the lease, which is redelivered by the pipeline to the lessee at Newhall, an offtake point well short of the market center. Thus location differentials in exchanges will not, as MMS appears to assume, invariably represent the differential between an "aggregation point" and a market center.

Third, MMS apparently proposes to assume that location differentials in exchanges will include quality differentials, and does not propose to differentiate between such differentials as a matter of course in its collection and publication of information. There are two separate and distinct types of differentials: (1) quality differentials, which have the separate components of gravity and sulfur and (2) location differentials. Each of these is unique to the crude being traded under the exchange, although they may be aggregated under the terms of any exchange. The utility of using such an aggregated location differential is questionable from both the standpoint of the receipt of the full amount of royalty due and from the standpoint of the particular federal lessee.

Fourth, MMS does not propose to adjust reported location differentials to account for the real transportation costs reflected in the exchange arrangements. Federal lessees, at the least, should be required to report the weighted average costs per barrel of transporting all the crude oil traded under the exchange.

5. The rules do not address how to select the appropriate market center

MMS does not address how a federal lessee or federal auditor is to determine the appropriate market center for calculation of the location differential.

SCO agrees with the City of Long Beach that lessees, particularly OCS lessees, should be limited to the differential reflecting the cheapest alternative as between transporting crude oil to Los Angeles or San Francisco. The comments of the City of Long Beach on this issue are incorporated by reference herein.

6. The rules do not address the treatment of gathering in calculating location differentials

Although MMS has not proposed any changes to its definition or treatment of gathering, it does not address how gathering is to be treated in the determination of location differentials.

Gathering -- the movement to a central accumulation point on or off the lease -- has never been treated as a deductible cost. This is because of the lessee's duty to market production at no cost to the lessor.

There is no sound reason to depart from that principle in this rulemaking. Yet MMS appears to be willing to allow lessees to include costs of gathering in the calculation of location differentials. MMS' definition of "aggregation point" as a practical matter will coincide with its definition of "gathering." Both involve movement to a central point for purposes of marketing. Since the nondeductibility of gathering has never been viewed as impacting MMS' determination of a wellhead value, there is no reason, other than making this rule more palatable to its detractors, to include gathering costs in the calculation of location differentials. Thus, SCO suggests that MMS clarify that calculation of costs from the lease to the aggregation point for purposes of computing location differentials does not include the costs of gathering.

B. MMS Does Not Adequately Address The Calculation Of Quality Differentials

As discussed above, MMS' proposal to assume that location differentials contain quality differentials will lead to distortions in the calculation of royalties to the detriment of both the government and some lessees. For example, assume two exchanges. Under the first, Midway Sunset crude oil at the lease is exchanged for Midway Sunset oil in Los Angeles. Under this exchange, any differential is attributable solely to location; there is no quality difference between the exchanged oil. However, under the second, Midway Sunset oil is exchanged for delivery back of oil at Line 63, which will be for oil of a mix of heavy and light. Under this exchange, any differential will include differences in both quality and location. Application of either of these differentials or some combination of the two, under Proposed §206.105(c)(1)(iii), to determine the location differential applied to a different type of transaction for a different oil will produce grossly inaccurate result.

And, as noted previously, any assumption that location differentials include applicable quality differentials also leaves open -- through aggregation, creative pricing of distinct differentials or transfer pricing -- an avenue for manipulation of royalty payments.

Such a result is not simply unwarranted, it is unnecessary, at least in California. There is a currently reliable gravity bank applied by ARCO's Four Corners pipeline that MMS can easily use to calculate quality differentials. Similarly, the All American Pipeline maintains a sulfur bank. Both of these pipelines are common carriers. Currently use of these banks will yield more accurate gravity and sulfur differentials and should be preferable on that basis and as a matter of administrative efficiency.

C. Two Alternative Means Of Calculating Differentials Exist; Either Of Which Should Be Employed By MMS On A Short Term Basis

As is clear, SCO, while agreeing with MMS' general theory of location differentials, does not believe that the means chosen by MMS for calculation of differentials will serve MMS' overall goal of collecting royalties based on the full value of federal production. SCO supports the idea that MMS should begin collecting, analyzing and auditing exchange agreements and other transportation arrangements, so that it can, in the future, better address the peculiar problems associated with calculation of location differentials. However, the risks and flaws in MMS' proposed approach are simply too serious for SCO to support it now. Indeed, at least for California, the net result under the MMS' proposed approach will, in many if not most cases, result in values no greater and possibly less than under posted price valuation.

There are two alternative means for calculating differentials that, in the interim, would prove more accurate than MMS' proposed approach. Under both, quality and sulfur differentials would be calculated using the common carrier banks referenced above.

The first approach, which was suggested above, would be to perform a regression analysis on the historical posted prices throughout the State, which would allow MMS to calculate a location differential for future use onshore. Since, for the reasons stated above, this would only yield an acceptable location differential for onshore production, a separate calculation based on actual costs is proposed for offshore production. In this regard, SCO proposes the following:

(1) for each company transporting crude oil produced or purchased at the lease and transported through a company owned pipeline, which is ultimately delivered to the company's refinery located at a market center, the location differential would be the average variable cost of transportation, but not including the costs of gathering, <u>or</u> the MMS calculated and published location differential as determined under (4) below, whichever is less.

(2) for each company transporting crude oil produced or purchased at the lease and transported by an unaffiliated entity to an unaffiliated refinery, the location differential would be the average variable cost of transportation, but not including the costs of gathering, <u>or</u> the MMS calculated and published location differential as determined under (4) below, whichever is less.

(3) for each company exchanging crude oil for the purposes of transportation, the location differential as stated in the exchange contract, provided that:

(a) the exchange is an in/out exchange to a market center in California;

(b) the location differential does not include a quality differential;

(c) to the extent that the contract aggregates differentials, the lessee must report the portion of the differential attributable to location and that attributable to gravity/sulfur but in no event will MMS accept a reported gravity/sulfur differential that exceeds the gravity/sulfur differential applied under the Four Corners Pipeline gravity bank and the All American Pipeline sulfur bank, and

(d) to the extent that the location differential in the exchange contract does not encompass full transportation costs from the lease to the market center, the average variable cost of transportation for the remaining portion of such transportation, but not including the costs of gathering.

(4) for purposes of the alternative valuation of location differentials in (1) and (2) above and for companies transporting to alternate disposal points in non-exchange transactions, trading crude oil under exchange agreements other than in/out exchanges or in other types of transactions, a location differential computed by MMS based on the information reported under (3) above and which shall be calculated on the basis of the weighted average per barrel cost of transportation from a lease to a market center in California.

The second alternative would be to apply the above "actual costs" method to all federal production in California.

Neither of these alternatives differ substantially from the MMS proposed approach; both follow the course MMS has already set and the basic theoretical underpinnings for determining location differentials that it wants to follow. However, both rid the MMS approach of its most objectionable elements -- reliance on irrelevant or inaccurate information, allowance of double dipping, and too rigid adherence to the MMS paradigm for crude movement from the lease to a market center.

SCO does not support the actual cost approach as the optimum means for determining location differentials. It is not administratively efficient. It will be heavily dependent on audits. However, SCO believes that the valuation portions of these rules should free up audit resources for devotion to transportation issues. This would prove particularly true if MMS abandons the gross proceeds valuation method. Moreover, the actual cost approach will result in differing location differentials for production transported from and to the same locations. Location differentials in such circumstances should not vary from lessee to lessee.

The benefit of the actual cost approach is that it will enable MMS to compile the type of information needed to promulgate easier and more accurate location differentials in the future.

This is particularly important in California where as a result of the current rules, the long history of private carrier pipeline operation, and the transfer pricing practices of some companies, MMS knows little about the true transportation costs for crude oil. Thus, SCO would accept an actual cost approach on a short term basis and suggests that it be adopted for a period no longer than three years.

SCO further suggests that MMS assign a special team of auditors and other transportation specialists that would be devoted to addressing the problematic area of location differentials in California and perhaps nationwide. The focus of the inquiry should be to determine the average variable cost of transporting crude oil through pipelines in California. Such an inquiry could begin immediately through review of the material obtained by California in conjunction with the reserved pipeline trial proceeding. We believe that a more thorough analysis of this problematic area of the MMS proposed rules could be easily conducted within a three year period. SCO notes that BLM followed a similar approach, *i.e.*, providing a "sunset" date, in its regulations for royalty rate reductions on stripper wells.

V. SECTION BY SECTION ANALYSIS

§206.101 - Definitions

SCO recommends the following changes to MMS' proposed regulations.

Area This definition, which is laden with interpretive problems, appears to be no longer needed under the draft valuation regulations.

Arm's Length Contract For the same reasons set forth by SCO in its comments to the 1988 regulations, this definition is too limited. At a minimum, to be arm's length a contract must have been entered in an open market. The captive market situations outlined in the Task

Force Report, as discussed previously, belie the existence of true arm's length contracts in the absence of any true open market. A "forced" sale at a price dictated by a buyer is simply not arm's length. In addition, contracts between joint venturers should be considered non-arm's-length.

Audit The definition should be reworded to assure that audits encompass review of transactions of a lessee's affiliates and others involved in the purchase, sale, transportation, marketing etc. of production from federal leases. In addition, a sentence should be added that this definition should not be construed to limit audit access to information from others who transact any business with a lessee or to information concerning the purchase, sale or transfer of production from non-federal leases.

Exchange Agreement This definition should be broadened to recognize the existence (and concomitant exclusions from §206.102 valuation) of multi-party exchanges, daisy chain transactions, exchanges for unfinished and finished products, overall balancing agreements, net-out agreements, and delayed or time exchanges. These types of exchanges and their impact on valuation are explained in the comments of the City of Long Beach, which are incorporated by reference herein.

As noted previously, the reference in the definition to transportation agreements, as currently worded, is confusing. Taken literally MMS' definition of "transportation agreements" would include all exchange agreements and thereby defeat or unnecessarily complicate other portions of MMS' proposed rule. *See e.g.*, §206.102(a)(3)(ii)(A). SCO recommends that MMS more specifically define what it means by its segregation of "transportation agreements" from the definition of "exchange agreements." For these reasons and those discussed above (pp. 28 -

30). SCO suggests that the definition of exchange agreement be modified to read as follows:

> *Exchange agreement* means reciprocal deliveries of oil or other products, both finished and unfinished, between one or more persons. Exchange agreements may or may not specify prices for the oil involved. They frequently specify dollar amounts reflecting location or quality differentials. Exchange agreements include, but are not limited to: "buy/sell" agreements, which specify prices to be paid at each exchange point and may appear to be two separate sales within the same agreement; agreements for reciprocal deliveries at different times; and agreements among persons designed to keep the volumes delivered in all their transactions in balance. For the sole purpose of the calculations to be made under §206.105(c), the term "exchange agreement" includes only those agreements under which one company transfers production to another company's pipeline and the latter transfers back an equal volume of crude oil at a different point along the same pipeline.

Field This definition appears to have no relevance under the draft valuation regulations and for that reason should be deleted.

Gathering A possibility of interpretive confusions exists between this definition and the proposed definition of *Aggregation Point*, especially since the proposal for determining the location differential when value is based on an index price provides for an allowance from the lease to the aggregation point. As discussed above (pp. 34-35), here and elsewhere it should be noted that, under certain circumstances, transportation to an aggregation point may be considered non-deductible gathering.

Gross proceeds The definition should be modified to include gross proceeds accruing to an entity affiliated with the lessee.

Index pricing The definition should specifically refer to the monthly average spot prices for Alaskan North Slope crude oil delivered to California.

B. §206.102 - Value

As discussed above, SCO recommends that MMS adopt ANS pricing as the sole determinant of value. In the alternative, SCO recommends that this entire section be recast as an exception to ANS pricing. SCO's recommended language for a gross proceeds exception was set out above, pp. 17 - 19. However, if MMS chooses to retain the gross proceeds valuation method in its benchmark system, SCO recommends the following modifications to §206.102(a).

§206.102(a)(2). The last sentence of this provision should be amended to read as follows (proposed changes underlined, deletions bracketed)

> If it does not, then MMS [may] shall require that you value the oil sold under that contract under paragraph (c)(2) of this section or the total consideration, whichever is greater.

If a lessee has not reported its total consideration in making its royalty payment, it has not complied with the gross proceeds rule. Failure to pay on the basis of total consideration may reflect other problems with the lessee's value calculation that justify application of paragraph (c)(2) valuation methods. However, in either event, MMS should not have the discretion to accept less than what would otherwise be owed under its own regulations.

§206.102(a)(4) through (a)(6). These sections should be deleted and replaced with the following:

> (4) You may not use paragraph (a) to value oil unless (i) you are an independent producer who does not operate a refinery, is not affiliated with any company that operates a refinery and produces no more than 20,000 barrels in any one state, and (ii) you are unable due to exceptional circumstances, *e.g.*, remote lease location, transportation constraints, from obtaining a better market for your production.
>
> (5) You may not use paragraph (a) to value oil if:
>
> (i) you disposed of the oil under an exchange agreement
>
> (ii) your production is subject to crude oil calls
>
> (iii) you or any of your affiliates purchased oil, gas, NGLs, or finished or unfinished products from an unaffiliated third party in the United States in the 2-year period preceding the production month. Where you or your affiliate participate as a buyer during a one year period after the time for royalty payment

has passed, you will be obligated to pay the difference between the royalty payment you made and the appropriate value under paragraph (c)(2), plus interest on the difference computed under 30 CFR §218.54.

(iv) your arm's length contract does not qualify as an actual sale of oil, as sale is defined in §206.101.

(v) you have sold oil under an arm's length contract that was subsequently sold or transferred back to you or an entity affiliated with you.

(vi) your arm's length sales contract specifies only posted price(s) as consideration.

(vii) you have sold oil under an arm's length contract but you received consideration under a subsequent sale of that oil.

(6) If your gross proceeds under paragraph (a) include payments made to reduce or buy down the purchase price of oil to be produced in later periods, you must allocate such payments over the production whose price the payment reduces and account for the payment as proceeds for the production as it occurs.

SCO's rationale for recommending these changes to §§206.102(a)(4) through (a)(6) are discussed above at pp. 15 - 20.

§206.102(c)(1). As discussed above, SCO recommends that MMS adopt ANS pricing as the sole determinant of value. In the alternative, SCO recommends that this section be recast, along with §206.102(a), as an exception to ANS pricing. SCO's recommended language for a gross proceeds exception was set out above, pp. 17 - 19. However, if MMS chooses to retain the affiliate sales/gross proceeds valuation method in its benchmark system, SCO recommends the following modifications to §206.102(c)(1).

First, under §206.102(c)(1), MMS has proposed to trace production from the lease through a series of affiliate sales. This will simply exacerbate the problems associated with determining the value of oil under the gross proceeds method that SCO outlined above. It will also involve more complicated transportation audits to the extent that subsequent affiliate sales move further from the lease or field. It will also permit greater use of the gross proceeds method of valuation, particularly by large integrated companies, and provide companies greater opportunities to avoid application of index pricing. Thus, initially, SCO recommends that MMS confine application of §206.102(c)(1) to transfers to affiliates. If subsequent non-arm's length transfers of oil to other affiliates occur, such production should be valued under §206.102(c)(2).

SCO does not believe that the affiliate sales/gross proceeds method of valuation should be available to integrated companies. Rather, as MMS notes in its preamble, the sole reason for retaining any gross proceeds methodology is to protect independent producers. If MMS agrees with SCO to limit §206.102(a) to true independent producers through adoption of the language suggested above, this would also limit the application of §206.102(c)(1) due to the limitations imposed under §206.102(c)(1)(i). In that event, SCO recommends that §206.102(c)(1) be modified to read as follows:

> (1) If you sell or transfer your oil production to an affiliate and that affiliate disposes of the oil under an arm's length sales contract, value is either:

However, if MMS does not adopt SCO's recommendation to limit application of the gross proceeds valuation method to true independent producers, SCO would still recommend that §206.102(c)(1) be modified to preclude its application by integrated companies. In that event, SCO recommends that §206.102(c)(1) be modified to read as follows:

> (1) If you sell or transfer your oil production to an affiliate and neither you nor any entity affiliated with you operates a refinery, value is either:

SCO also recommends that §206.102(c)(i) be modified to address the problem of commingled oil and multiple sales by affiliates discussed above, at pp. 13 -14. SCO suggests the following language:

> (i) the gross proceeds accruing to your affiliate under its arm's length sales contract(s), subject to the same limitations on acceptance of such proceeds under paragraph (a). If your affiliate commingles oil purchased from you with oil purchased from others and sells such commingled oil under more than one arm's length contract, gross proceeds shall be determined under the contract with the highest value basis.

§206.102(c)(2). Under §§206.102(c)(2) sets out the requirements for index based valuation. As noted, SCO supports application of pricing for valuation of crude oil in California. However, in both the provision for applying NYMEX pricing and for ANS pricing, MMS proposes to allow lessees to deduct both location/quality differentials and transportation costs. This is what a plain reading of both paragraphs (c)(2)(i) and (c)(2)(ii) provides and is another example of MMS' confusion of wholly separate concepts -- location differentials and transportation allowances. As discussed previously, once a location differential is calculated and applied to an index price, MMS will have a wellhead value for its production. Under such circumstances, there is no authority that would support extending lessees an additional deduction for transportation. Transportation allowances have historically only been allowed when a sale takes place away from the lease; a deduction is then necessary in order to determine a wellhead value. Under MMS' proposal, the only remaining relevance of transportation allowances would be in the application of Proposed §§206.102(a) or 206.102(c)(1), the gross proceeds valuation methods. Even then, such allowances would not be allowable for sales taking place at the lease. Allowing both under §206.102(c)(2) is either simply an absurd authorization of "double dipping" or a conversion of the federal government's royalty interest into a working interest.

Accordingly, SCO specifically requests that the language "and you may adjust it for transportation costs under §206.105(c) of this subpart" be DELETED from §§206.102(c)(2)(i) and §206.102(c)(2)(ii).

§206.102(c)(3). As discussed previously, SCO recommends that MMS specifically set out a "safety net" method for valuation, rather than leaving the need for an alternative to be addressed through a protracted rulemaking. SCO's suggested language is set out on p. 10.

§206.102(g). SCO recommends that this section be modified to specifically reflect that MMS' determinations of value under §206.102(f) are subject to modification or revision through audit. MMS should not be bound to a valuation determination that audit reveals was based on inaccurate or incomplete submission of data by a lessee. SCO suggests the following language:

> (g) How do value redeterminations relate to audit periods? No review, reconciliation, monitoring, value determination made under paragraph (f) or other like process that results in MMS determining your oil royalty value will be considered final or binding on the Federal Government until MMS formally closes the audit period ....

New §§206.102(i) and 206.102(j). As previously discussed, several avenues exist under the MMS' proposed regulations that would enable companies to take advantage of the gross proceeds methodology. For example, SCO has learned that in California some independent producers sell their production to an association in what would be an "arm's length" contract under MMS rules. SCO believes that this association than sells the production at higher prices to the benefit of its members. Yet, under the MMS proposed rules, these independent producers would be permitted to value their production under the gross proceeds of the first arm's length sale. SCO also noted that "daisy chain" transactions would also enable companies to take advantage of the gross proceeds valuation method.

If MMS is to retain the gross proceeds valuation method, there is no way that it can predict and set out in rules all of the various contractual arrangements that could serve to impede its collection of the true value of production. However, MMS can still provide for a mechanism of protection by establishing an anti-circumvention rule. SCO notes that DOE promulgated such a rule in its price control regulations. *See e.g.*, 10 CFR §205.202. SCO proposes that MMS do likewise and recommends the following language for a new §206.102(i):

> If MMS determines that you have entered into any transactions that serve to circumvent payment of the reasonable royalty value or application of this section, MMS shall redetermine the value of your production. You must pay the difference between the royalty payments you made and those that are due based upon the value established by MMS. You must also pay interest on the difference computed under 30 CFR §218.54. If circumstances warrant, you may also be subject to penalties and/or lease cancellation.

While SCO does not believe that MMS should retain the gross proceeds valuation method as a benchmark method of valuation, it does support the continued use of that method as the minimum acceptable value for royalty purposes. The gross proceeds minimum can serve as an important cross check that MMS is actually receiving the full amount owed. Thus SCO recommends that a new §206.102(j) be included to read as follows:

> (j) Under no circumstances shall the value of production for royalty purposes be less than the gross proceeds, as defined in this Part, less applicable allowances.

C. §206.104 - Transportation allowances and other adjustments - general

§206.104(b). Here again, MMS has inserted language that confuses the distinctions between a "transportation allowance" and a "location differential" in a manner that suggests that federal lessees are entitled to both. Even if unintended by MMS, such melting of these separate concepts can only lead to confusion and potential loss of royalty income. SCO recognizes that MMS provides for some consideration of "actual costs" in its proposed method for determining location differentials. However, it must be made clear that consideration of actual costs in deriving a location differential is not the same as a "transportation allowance."

SCO recommends that §206.104(b) be modified to read as follows:

(b) *What transportation allowances and other adjustments apply when I value production* *based on index pricing?* If you value your production based on index pricing, you are not entitled to a transportation allowance. The absolute value of the applicable index based price under §206.102(c)(2)(i) [NYMEX] or §206.102(c)(2)(ii) [ANS] will be adjusted to reflect its relative advantages or disadvantages in terms of location and quality in order to determine a wellhead value. The calculation of such location and quality differentials is set out in §206.105(c).

SCO notes that conforming modifications distinguishing between transportation allowances, location differentials and quality differentials need to be made throughout MMS' proposed rule. Indeed, the possibility for confusion due to MMS' fusion of these wholly separate concepts is so great that SCO recommends that MMS deal with transportation allowances, location differentials and quality differentials in separate sections of the final regulations. While this may result in some repetition of certain discrete elements that are common to all of the concepts, overall the increase in clarity to both auditors and lessees and the safeguards in collection of the true value of production that would result in separate treatment counsels strongly for undertaking the task.

§206.104(c). This section suffers from the same flaws of §206.104(b). Moreover, SCO believes that the reference to a "transportation allowance" not exceeding 50% of the value of the oil at the "aggregation point" is nonsensical. Under MMS' paradigm, the costs of transportation from lease to the aggregation point "leg" will rarely exceed 50%. Indeed, as discussed more fully above, SCO believes that much of this "cost" will be nondeductible gathering.

If in this section, MMS is actually referring to the times under its location differential regulations where an "alternative destination point" will be deemed an "aggregation point," SCO has already demonstrated that, at least in California, this regulatory provision results in impermissible "double dipping" of "costs," and that thus it should be deleted from the regulations for calculation of location differentials.

SCO would agree that a location differential should never exceed 50% of the value of the oil at the market center or index pricing point without MMS approval, but this is not what MMS has provided for under §206.104(c).

§206.104(e). As with the last two provisions discussed, because of MMS' melting of the concepts of "transportation allowance" and "location differential," the application of this section is uncertain. MMS simply does not address, for example, what additional payments a lessee would be liable for if it calculates an excessive location differential. Are auditors and lessees supposed to assume that the reference to "transportation allowance" in this section encompasses "location differentials," despite the fact that these are separately defined terms under §206.101?

In any event, the confusion that this provision can cause serves as further support for SCO's recommendation that MMS segregate its treatment of transportation allowances, location differentials and quality differentials in different sections of its regulations.

D. §206.105 - Determination of transportation allowances and other adjustments

§206.105(c). For the reasons stated above, SCO recommends that this entire section be segregated from MMS' section dealing with the calculation of transportation allowances and that all references to the term "transportation allowance" be deleted.

As SCO demonstrated above, the information MMS proposes to use for the calculation of a location differential for particular federal lease production will not invariably fall within MMS' paradigm for movement from the lease to the market center. Thus, at most, the factors listed under §206.105(c)(1) can only serve as examples of the types of factors MMS will use in calculating a location differential. Literal application of these factors, as noted, will result in inflation of the true location differential in many instances, at least in California, to the detriment of both the federal government and some lessees. Until MMS learns more about the calculation of location differentials, through further study and audit, SCO believes that more flexibility needs to be built into this rule. Thus it recommends that MMS begin §206.105(c)(1) with an explanation for auditors and lessees as to what a location differential is intended to capture. This should be coupled with a caution that the factors listed under §206.105(c)(1)(i) through (c)(1)(v) will not be applied rigidly if they do not reflect the true differential applicable to the oil.

SCO suggests the following language:

> ( ) *What adjustments for location apply when I use index pricing?* When you use index pricing to calculate the value of production under §206.102(c)(2), the applicable index price must be adjusted to reflect its relative advantages or disadvantages attributable to its location. Examples of the adjustments that might apply to your production are listed in paragraphs (c)(1)(i) through (v) of this section. These factors are based on movement from the index pricing point to the lease through a market center and an aggregation point. Application of one or more of the adjustments listed in paragraphs (c)(1)(i) through (v) to your production, however, will depend on the extent that the agreements or other documentation you use to calculate the location differential accurately reflects the true costs associated with movement through the different location segments from the index pricing point to the lease. Paragraphs (c)(2) through (c)(3) of this section describe how the adjustments listed in paragraphs (c)(1)(i) through (v) of this section might apply to your production based on how your dispose of your production and where your leases are located. If application of (c)(2) through (c)(3) will result in double recovery of the true costs associated with movement through the different location segments from the index pricing point to the lease, you must file a request with MMS for calculation of a location differential under paragraph (c)(4).

For the reasons stated above, pp. 34 - 35, regarding the non-deductibility of gathering costs, SCO recommends that §206.105(c)(1)(iv) be modified to read as follows:

> (iv) Actual transportation costs from the aggregation point to the leases, but excluding the costs of gathering.

SCO's recommended changes to §206.105(c)(3) and the rationale therefor are set out on pp. 23 - 33.

Finally, SCO recommends that MMS modify §206.105(c)(4) in two respects.

First, currently MMS provides that a lessee may only seek an MMS calculated location differential if the differential calculated by MMS under §206.105(c)(1)(iii) is inapplicable to the lessee's particular federal production. As noted above however literal application of MMS' proposals for location differentials can lead to double recovery of costs associated with one or several of the segments under MMS' paradigm for location differentials. For example, this could happen under Proposed §§206.105(c)(2)(1) or (c)(2)(iv) where an exchange agreement differential actually reflects a transfer at the lease rather than at an "aggregation point." In the first instance, only the lessee will know whether double recovery will result and thus it should be the lessee's obligation to bring that fact to the attention of MMS through a request for calculation of a location differential under §206.105(4).

Second, an MMS calculated location differential should explicitly be made subject to audit. The information provided by the lessee for a request must eventually be verified.

Accordingly, SCO recommends that §206.105(4) be modified to read as follows:

> (4) If a differential under paragraphs (c)(2) or (c)(3) of this section does not apply to your oil, either due to location differences or because application of the adjustments would result in double recovery, you must request MMS to calculate a differential for you.
>
> > (i) You must file your request in writing with MMS within 30 days after the month of production.
> >
> > (ii) You must provide clear evidence demonstrating why the application of paragraphs (c)(2) or (c)(3) does not adequately reflect your circumstances.
> >
> > (iii) If you do not file a request within 30 days after the month of production, MMS will calculate such a differential when it receives your request or when it discovers that the differential applied by you does not apply to your oil. MMS will bill you for any additional royalties and interest due. MMS will not refund any overpayments you made due to your failure to timely request MMS to calculate a differential for you.

(iv) All MMS calculated differentials under this paragraph remain open to correction or modification after audit.

(v) File your request at the following address: Minerals Management Service, Royalty Management Program, Valuation and Standards Division, P.O. Box 25165, Mail Stop 3150, Denver, CO 80225-0165.

New §206.105(c)(9). As discussed previously, pp. 28 - 29, transfer pricing practices and the ability of lessees to aggregate differentials poses a potential problem for determination of the true value of federal production. There is no way that MMS can predict and set out in rules all of the various contractual arrangements that could serve to impede its collection of the true value of production. However, MMS can still provide for a mechanism of protection by establishing an anti-circumvention rule. SCO notes that DOE promulgated such a rule in its price control regulations. *See e.g.*, 10 CFR §205.202. SCO proposes that MMS do likewise and recommends the following language for a new §206.105(c)(9):

> If MMS determines that you have entered into any transactions that serve to circumvent payment of the reasonable royalty value or application of this section, MMS shall redetermine the value of your production. You must pay the difference between the royalty payments you made and those that are due based upon the value established by MMS. You must also pay interest on the difference computed under 30 CFR §218.54. If circumstances warrant, you may also be subject to penalties and/or lease cancellation.

SCO notes that this language is identical to its proposed new §206.102(i). It is recommended here because the same types of contractual problems can impact the determination of location differentials.

VI. MISCELLANEOUS ISSUES

SCO supports MMS' proposed deletion of §206.105(b) from its current regulations governing the calculation of transportation allowances where production is transferred under non-arm's length contracts.

As MMS rightly notes, the Federal Energy Regulatory Commission has ruled that it does not have jurisdiction over offshore pipelines located wholly on the outer continental shelf. Yet, this is only one of the reasons justifying MMS' proposed deletion of §206.105(b).

There is a particular problem with tariffs filed with FERC for transport on offshore pipelines in California. Little, if any, review has been conducted on the reasonableness of the field rates. On their face, the tariffs for these pipelines are exorbitant and the available financial data demonstrates an unjustifiable level of profit from their operation. SCO again notes, for example, that the 26 mile pipeline serving Point Arguello is among the ten most profitable pipelines nationwide. *See e.g.*, Oil & Gas Journal (November 27, 1995). The few tariffs for onshore pipelines operating in California likely do not reflect actual transportation costs throughout the State. Interior is not bound by tariffs filed with other agencies in determining the federal government's royalty interests. In non-arm's length situations, there is simply nothing unfair about confining lessees to calculation of any applicable transportation allowance to their actual costs.

SCO also supports MMS' proposal to value production taken in kind by application of index pricing. For too long, MMS has permitted the value of in kind production to be dictated by the prices reported by federal lessees. This has invariably led to valuation based on posted prices, whether or not this was the value that should have been reported by the lessees. *See e.g.*, §208.2 (definition of "fair market value" for purposes of offshore RIK sales). Indeed, SCO believes that MMS has not been as aggressive as it could in monitoring the prices reported by federal lessees for valuation of in kind royalties. *See e.g., ARCO Oil & Gas Co.*, 131 IBLA 299 (1994). Reliance on index pricing will enable MMS to free itself from dependence on lessees for determining in kind values.

SCO does share the concerns expressed by the City of Long Beach about the calculation of transportation allowances to offshore in kind sales. Since application of index based pricing adjusted for location will determine a wellhead value, there is little remaining reason for MMS to recognize transportation allowances. SCO urges MMS to recognize that fact in any future offshore in kind sales and to modify Proposed §§206.104(a)(1) and (a)(2) accordingly.

Respectfully submitted,

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